Third Quarter Numbers: Reduce Expenses… Again!
by Charles Wendel

Each quarter my colleague, Bob Browne, sends out the most recent FDIC bank performance data to clients and friends. For any investor or analyst, this database of 6,000 banks offers a treasure trove of information. It allows us to assess banks based on one or more of multiple characteristics such as ROE or ROA. While the numbers tell a reasonably good story (at least in terms of asset quality), this quarter's results indicate that banks should address one critical area immediately; operating expenses (efficiency ratios) continue to be out of control at many banks.

A 2012 FDIC article summarizes how to calculate an efficiency ratio and what it means for banks:

"The efficiency ratio is a simple expression of the underlying operational performance of banks apart from differences in performance caused by asset quality factors. It compares the level of overhead costs (total noninterest expense) to net operating revenues (the sum of net interest income and total noninterest income). A higher efficiency ratio actually suggests inefficiency, as it indicates that the bank is less productive in terms of converting expenditures into revenue."

In effect, a bank's efficiency ratio captures what it costs a bank to generate its revenues. Generally, the more you spend to make current money, the less you have for investments and/or to share with stakeholders.

Here's three damning numbers from the 2017 third-quarter report:

- 1,015 banks have an operating efficiency number of 80% or more
- Another 1,272 have an efficiency number between 70% and 80%
- This total of 2,287 banks represents more than 30% of all U.S. banks

How do a bank make profits with ratios like these? The answer in most cases is "very slowly, if at all."

These disastrous numbers exist despite a strong credit environment and relatively low losses. But, no doubt bank management can list multiple reasons why costs remain high:

- Costs related to various external regulations
- Costs related to internal compliance
- Costs related to cybersecurity
- Costs related to vendor management
- Costs related to internal processes that check the checkers
- Costs related to technology expenses

As regulators increase their requirements and as technology issues and threats become more complex, costs continue to rise. Note that in most cases the higher costs have no linkage to the pursuit of increased revenues or profits. The list goes on with each bank and credit union addressing some similar but often-distinct cost pain points.

It almost does not matter why the cost levels are where they are; the mandate from Boards and top management should be to improve the efficiency ratio ASAP while maintaining all critical processes and meeting regulatory requirements. And this is where old-fashioned organizational improvements and new initiatives tied to Fintech and Regtech can combine to reduce expenses and allow increased focus on the revenue line.

Banks and credit unions should be exploiting (in the best sense of that word) Fintech and Regtech for all they are worth, and, potentially, they are worth a great deal. What we often find instead is a reticence on the part of senior management to move away from past approaches, no matter their inefficiencies. One banker recently expressed his frustration at his top management rejecting a cost saving approach that he and the CIO both recommended. Basically, the response they received was that the bank had certain ways of doing things and was not changing its approach. Despite the cost savings and little risk entailed in an IT-based solution, management was not willing to act. Maybe later.

Of course it is a mistake to overanalyze any one number, including operating expenses. Some banks may have artificially low numbers by sacrificing important expense decisions for near-term earnings. One bank we know that has a very low expense number deliberately increased its costs in light of required IT and other investments. Each metric needs to be peeled back to determine its components and the value provided by expense dollars. However, the 2,287 banks with expense ratios above 70% should immediately conduct an independent review reporting to TOP management and the Board as soon as possible to determine key expense categories, their specific components, as well as opportunities to reduce costs while maintaining what I term institutional integrity.

Why an independent review reporting to top management and the Board? Banks should NOT do this on their own if they want to achieve meaningful results. A consulting friend told me a story about an event earlier in his career. He developed a detailed recommendation that would have allowed an IT-based solution to replace most of a certain functional group's employees. Naively, he presented his findings to the head of that group who reacted to those recommendations by asking what would happen to his own job if most of his reports disappeared. Given human nature, that manager's response was unsurprising (my friend was dismissed along with his recommendation), but it was harmful to the bank and its owners.

If, as many do, a bank pursues an operating expense review on its own, results will be marginalized in light of employee self-interest and parochialism. That may be one reason why after years of focus on cost reduction, many banks show worse numbers that ever. Reducing costs is not easy, but, if top management leads the effort, a balance of organizational change and targeted technology can provide dramatic improvement.